

**STRICTLY CONFIDENTIAL (FR) CLASS I-FOMC**

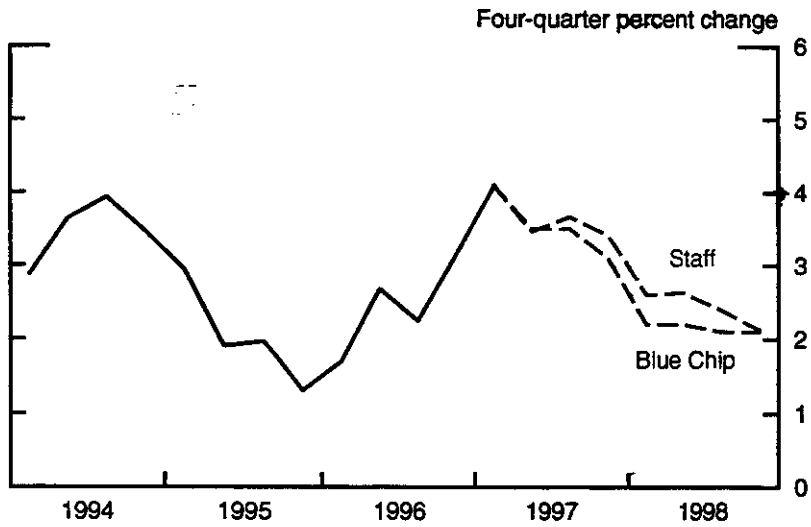
*Material for*  
*Staff Presentation to the*  
*Federal Open Market Committee*

*July 1, 1997*

Chart 1

# Forecast Summary

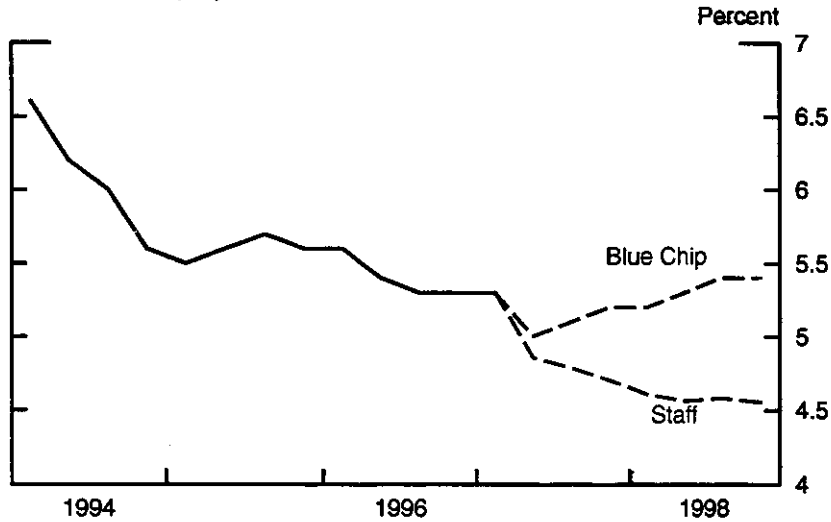
## Real GDP



### Q4/Q4 percent change

1994	3.5
1995	1.3
1996	3.1
1997	3.4
1998	2.1

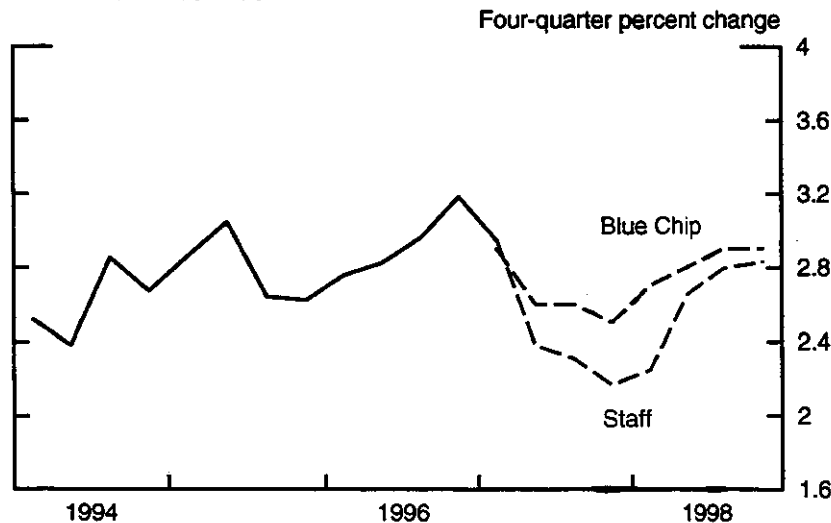
## Civilian Unemployment Rate



### Percent (fourth quarter)

1994	5.6
1995	5.6
1996	5.3
1997	4.7
1998	4.6

## Consumer Price Index



### Q4/Q4 percent change

	Ex. food & energy		
	Total	Actual	Adj.*
1994	2.7	2.8	2.8
1995	2.6	3.0	3.1
1996	3.2	2.6	2.8
1997	2.2	2.7	3.0
1998	2.8	3.0	3.4

\*Adjusted for technical changes

Note: "Consensus" forecast, Blue Chip Economic Indicators, June 10, 1997.

## Background Factors in the Staff Forecast

### Financial environment

- Federal funds rate remains at current level this year and then moves up moderately in 1998.
- Long-term rates begin to firm later this year reflecting inflation concerns, and rise a bit further next year as the System tightens.
- Stock prices climb further in the next few months; but disappointing profits, coupled with higher interest rates, lead to an appreciable correction next year.

### Fiscal policy

- The deficit widens slightly.
- Revenue growth slows in FY98, while outlays increase at about the pace of recent years.
- The macroeconomic consequences should be negligible.

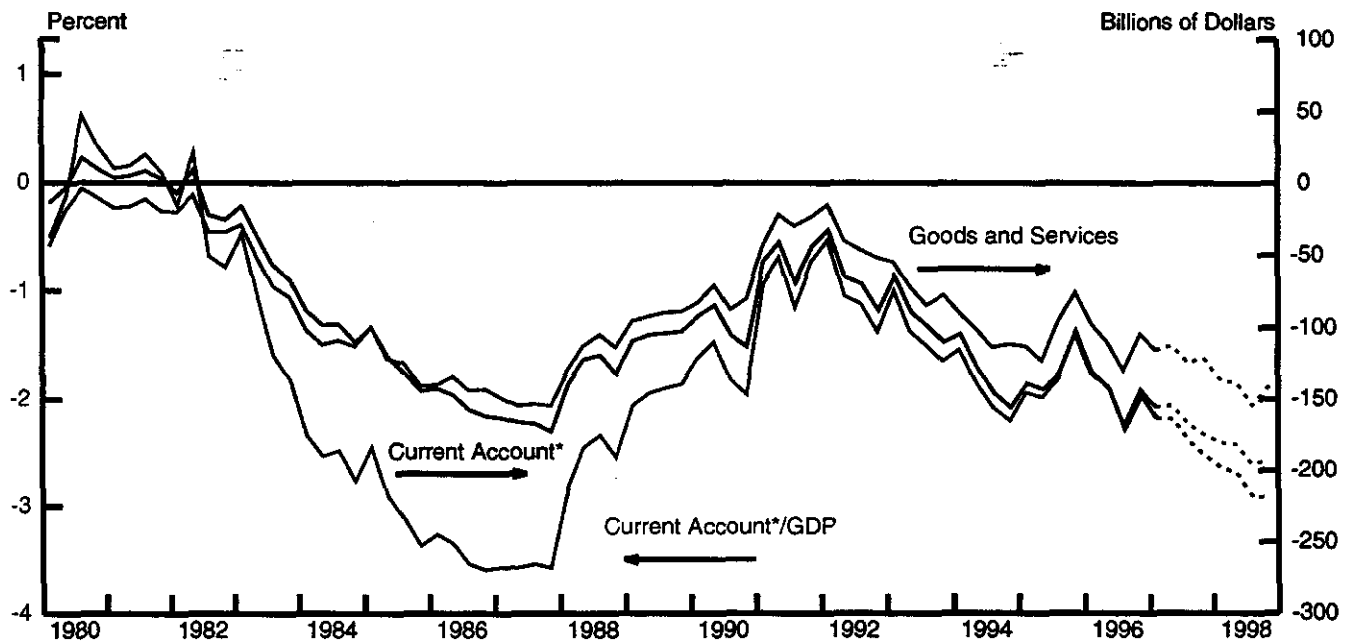
### Federal Fiscal Indicators

	1995	1996	1997	1998
Unified deficit (\$billions, fiscal year)	163.9	107.2	59.1	84.7
Fiscal impetus (calendar year)*	-.4	-.1	-.2	-.1

\* Percent of GDP; negative values indicate restraint.

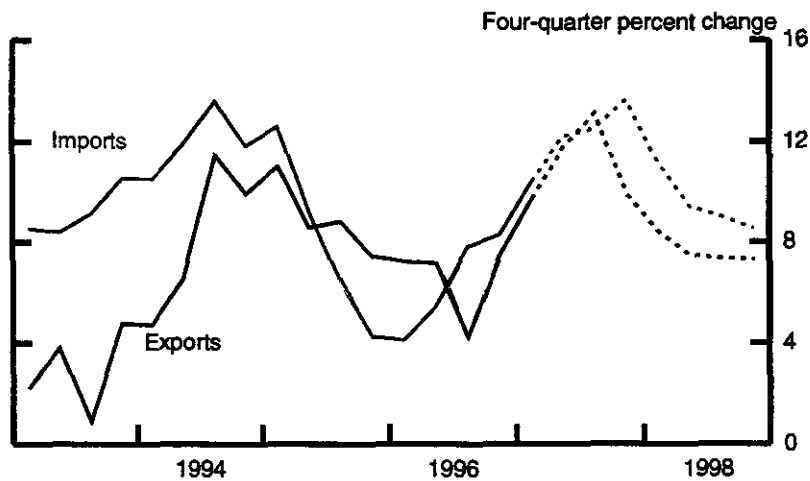
Chart 3

## Forecast Summary: External Sector



\* Excludes cash grants received for the Gulf War.

### U.S. Real Net Exports of Goods and Services



### Contribution to Real GDP Growth\*

#### Percentage Points

1995-H1	-0.5
1995-H2	1.1
1996-H1	-0.9
1996-H2	0.5
1997-H1	-1.0
1997-H2	-0.3
1998-H1	-0.5
1998-H2	-0.2

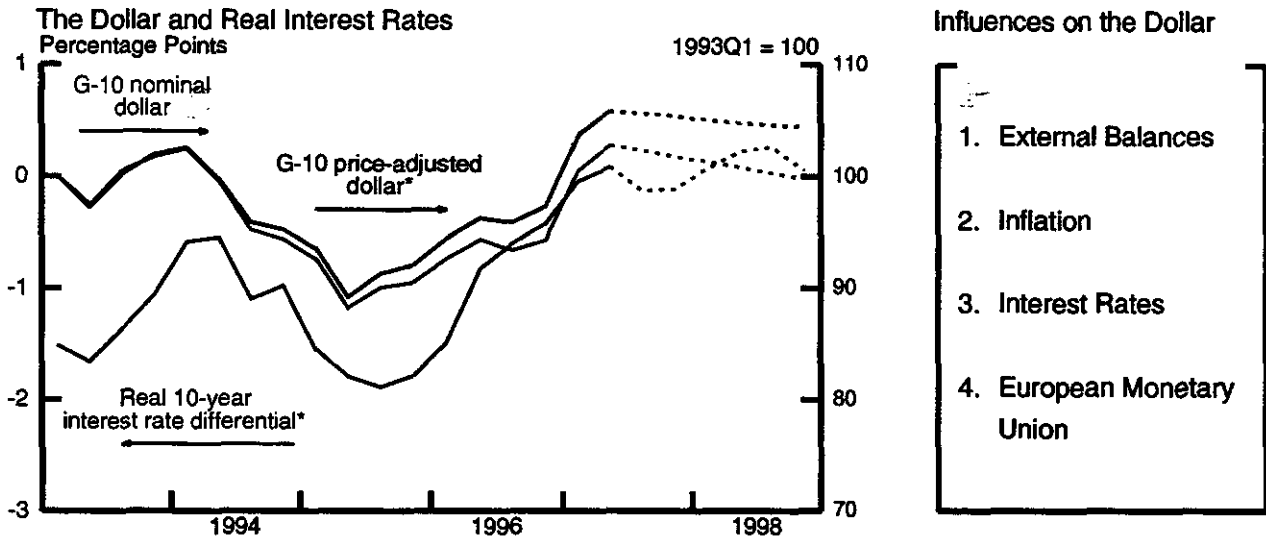
\* From end of previous period.

### Issues in the Outlook

1. Exchange Rates
2. Foreign Outlook
3. Imports

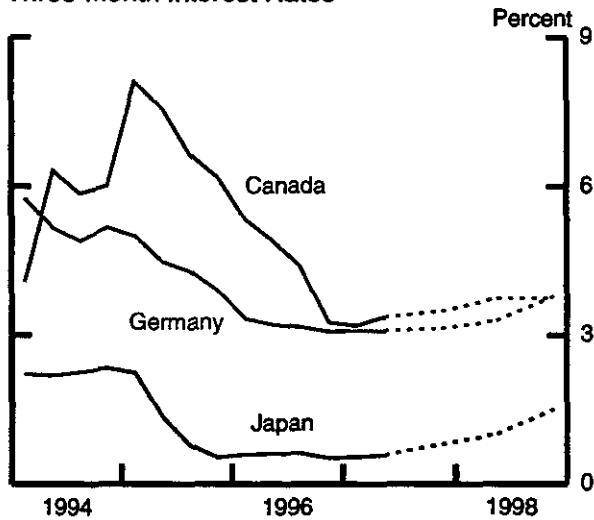
Chart 4

## Exchange Rates and Interest Rates

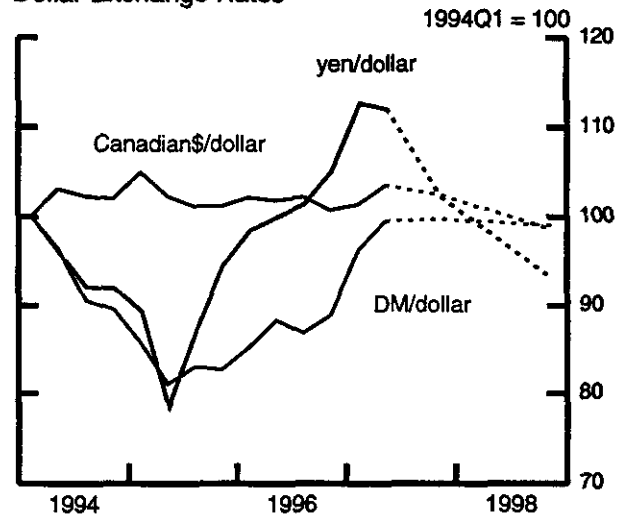


\*Adjusted by consumer prices.

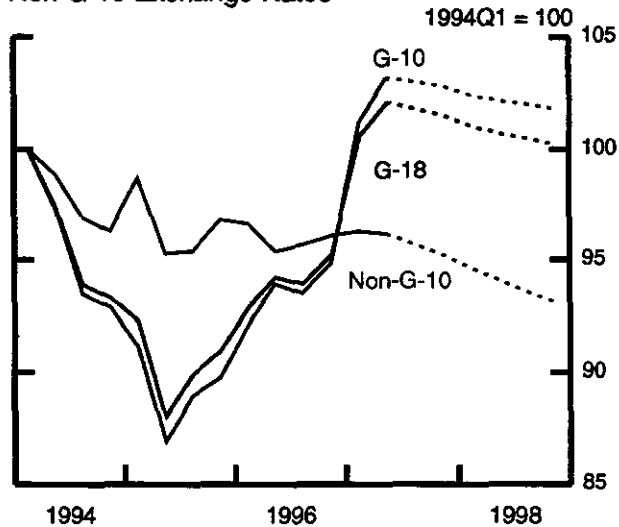
**Three-Month Interest Rates**



**Dollar Exchange Rates**



**Non-G-10 Exchange Rates\***



\*Adjusted by consumer prices.

**Mexican Peso/Dollar\***

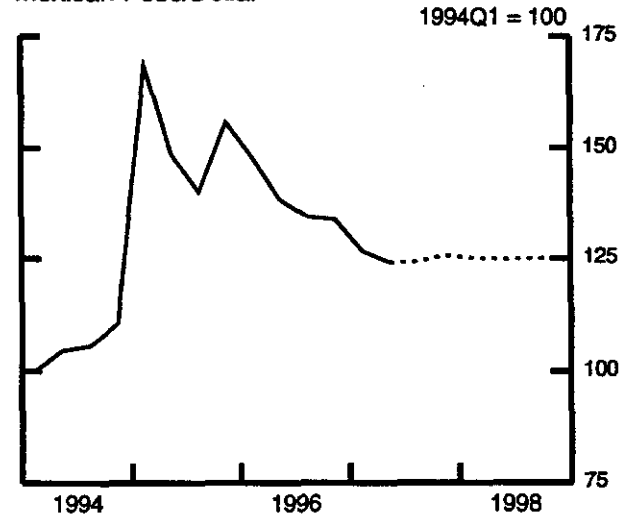
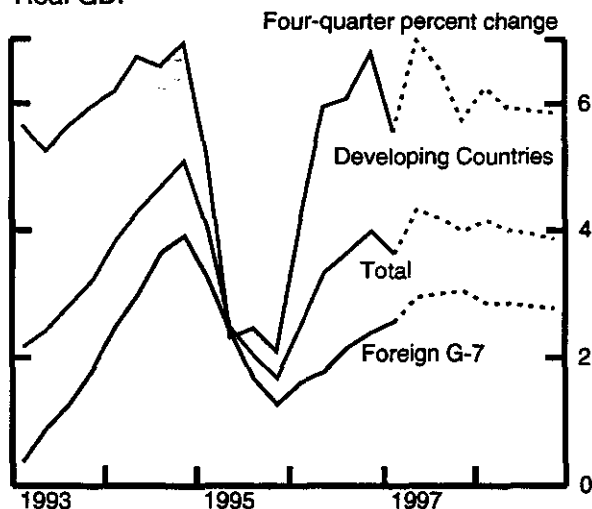


Chart 5

## Foreign Outlook and U.S. Exports

Real GDP\*



\* U.S. non-agricultural export weights.

Percent change, Q4 to Q4

	1996	1997	1998
Japan	3.0	2.6	2.4
Canada	2.3	3.5	3.2
United Kingdom	2.8	3.1	2.2
Euro Area**	2.2	2.8	2.7
Mexico	7.6	4.7	4.3
Other Latin Am.	4.2	3.9	4.0
Other Asia	6.9	6.6	7.0
<b>Total*</b>	<b>4.0</b>	<b>4.0</b>	<b>3.9</b>
Memo: United States	3.1	3.4	2.1

\*\* Euro Area is EU-15 less Denmark, Greece, Sweden, U.K.

Consumer Prices

Percent change, Q4 to Q4

	1996	1997	1998
Japan	0.1	1.5	0.6
Canada	2.0	1.4	1.6
United Kingdom	3.2	2.6	2.7
Euro Area*	1.9	1.7	1.8
Mexico	28.1	19.0	12.5
Other Developing*	4.2	4.0	4.4
<b>Total*</b>	<b>4.1</b>	<b>3.5</b>	<b>2.9</b>
Memo: United States	3.2	2.1	2.8

\* U.S. non-oil import weights; harmonized indexes for Euro Area

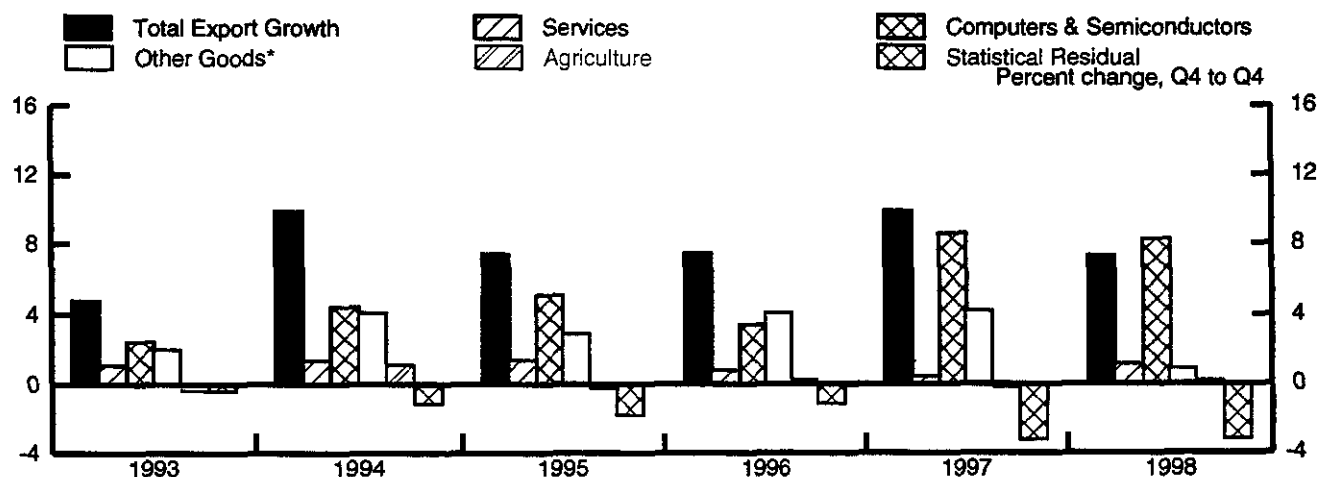
Output Gaps

Percent of Potential

	1996Q4	1998Q4
Japan	-1.5	-0.5
Canada	-2.6	-0.8
United Kingdom	-0.4	0.2
Euro Area*	-2.0	-1.3
Germany	-1.0	-0.5
France	-2.2	-0.9
Italy	-3.1	-3.0

\* GDP weights.

Contribution to Growth in Real Exports of Goods and Services

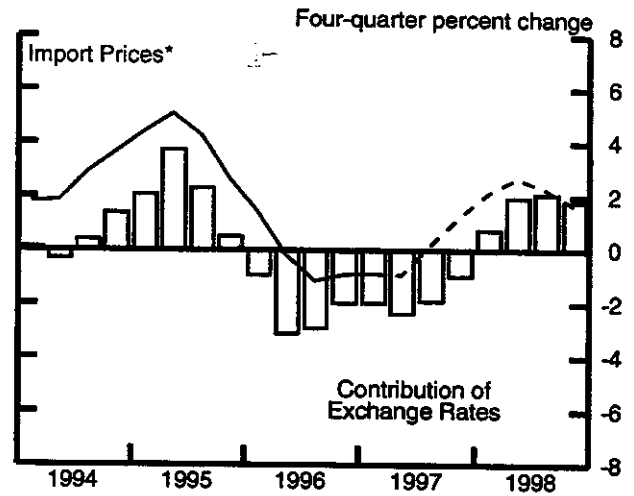
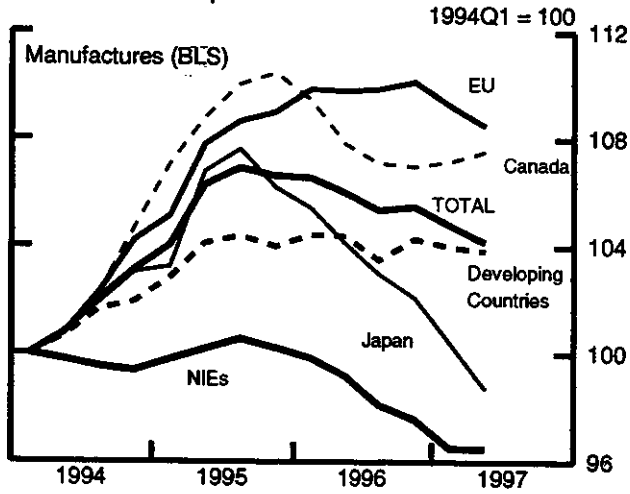


\* Excluding agriculture, computers and semiconductors.

Chart 6

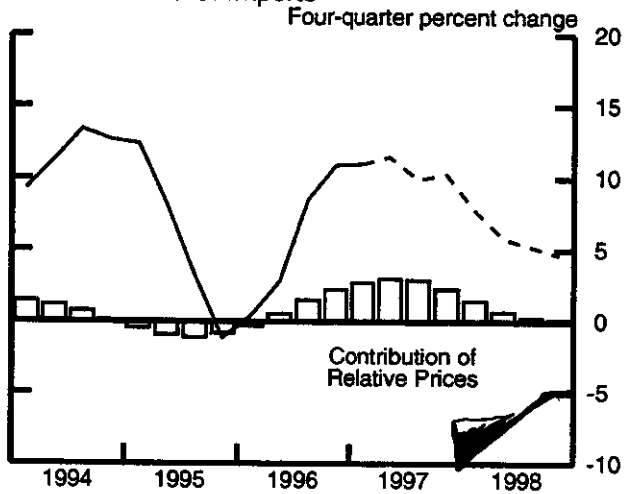
# U.S. Imports

Prices of U.S. Imports

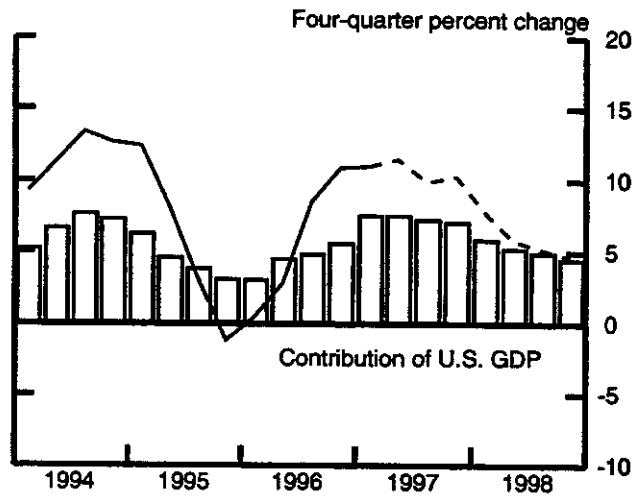


\* Excluding oil, computers, and semiconductors; derived from NIPA.

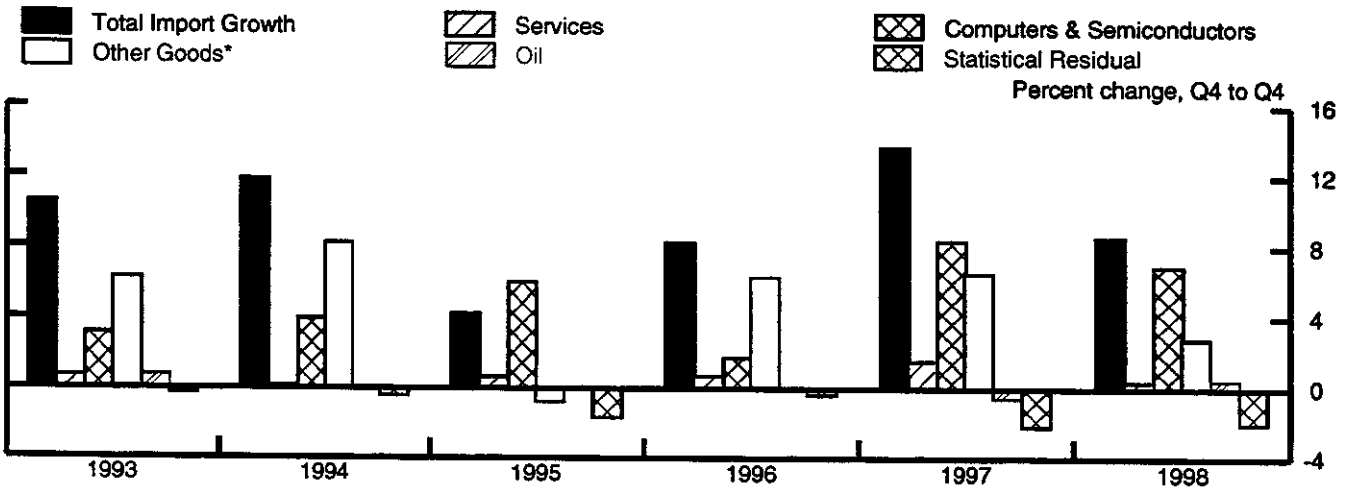
Quantities of U.S. Imports\*



\* Excluding oil, computers, and semiconductors.



Contribution to Growth of Real Imports of Goods and Services

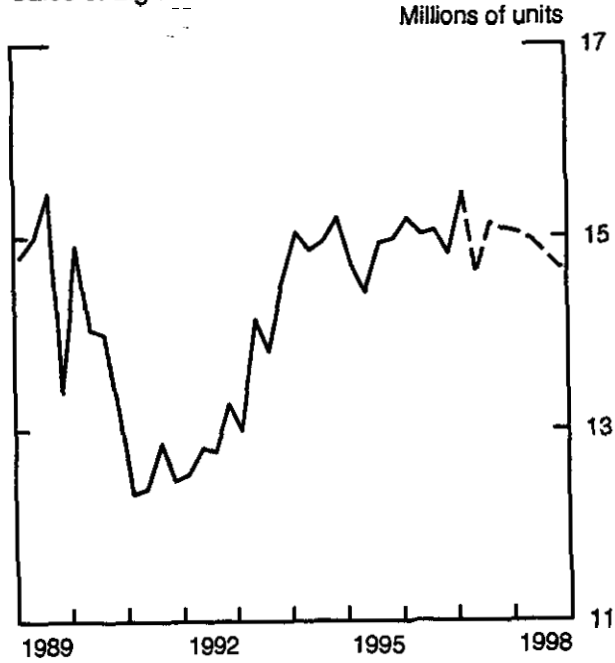


\* Excluding oil, computers, and semiconductors.

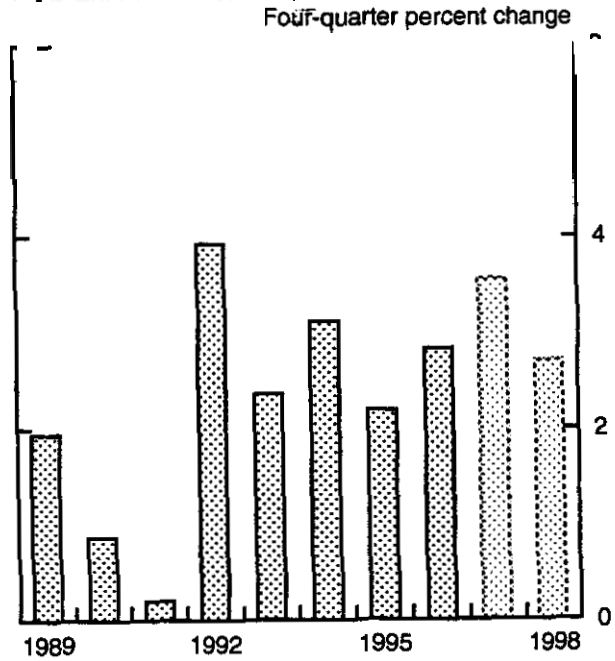
Chart 7

## Consumption

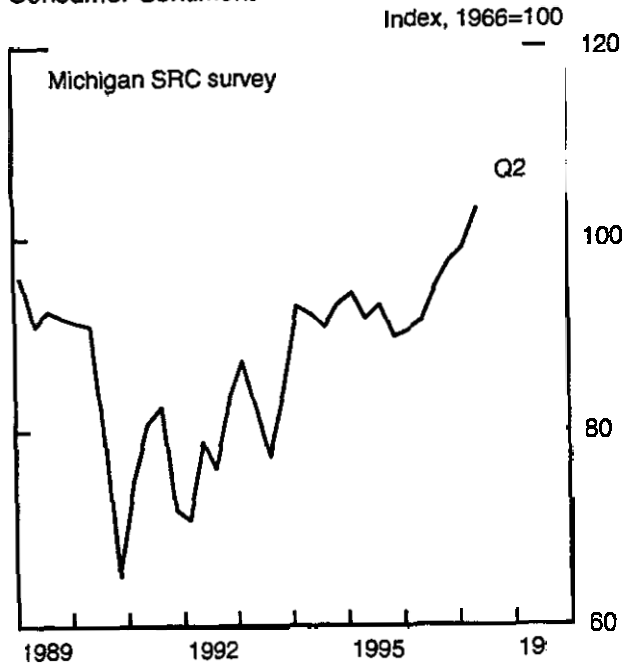
Sales of Light Vehicles



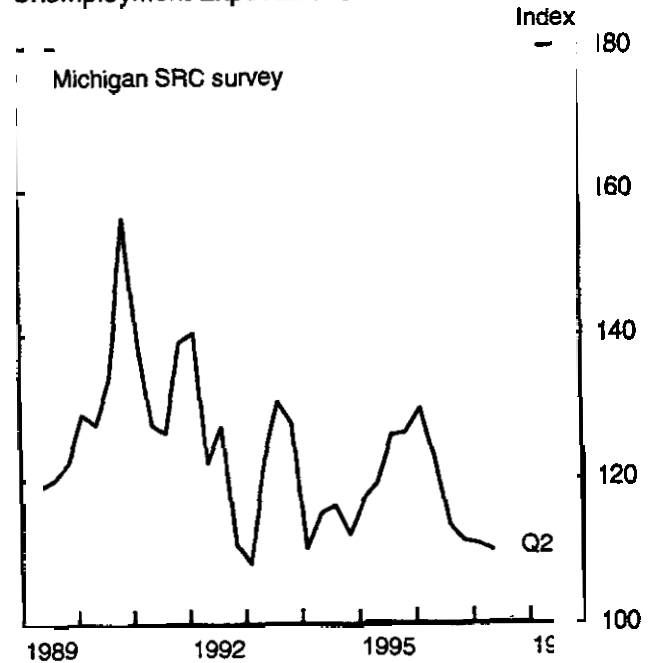
PCE Ex. Motor Vehicles



Consumer Sentiment



Unemployment Expectations

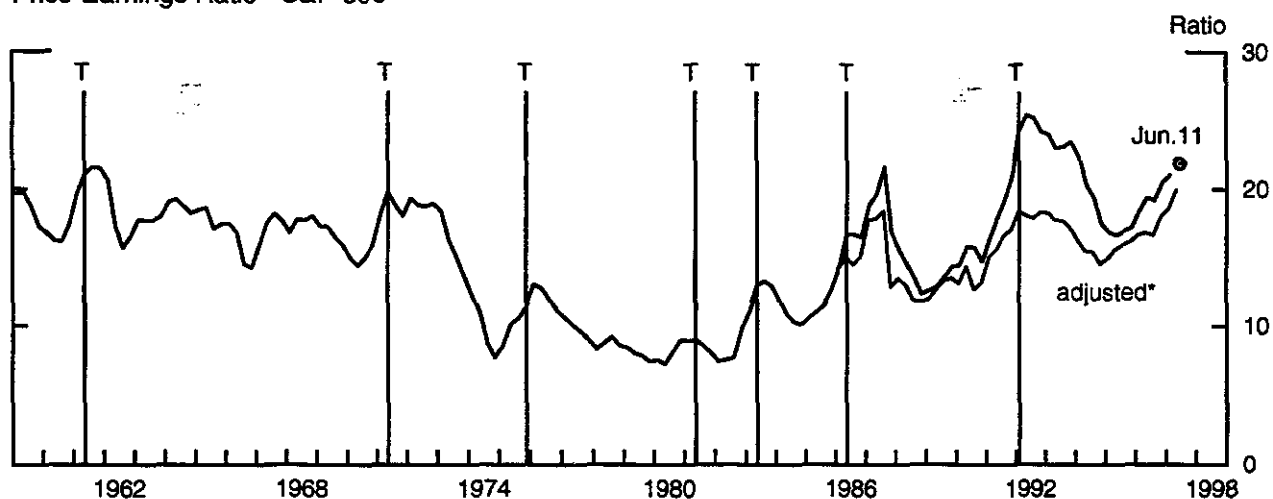


Note. Percent expecting unemployment to rise over next 12 months less those expecting unemployment to fall plus 100.



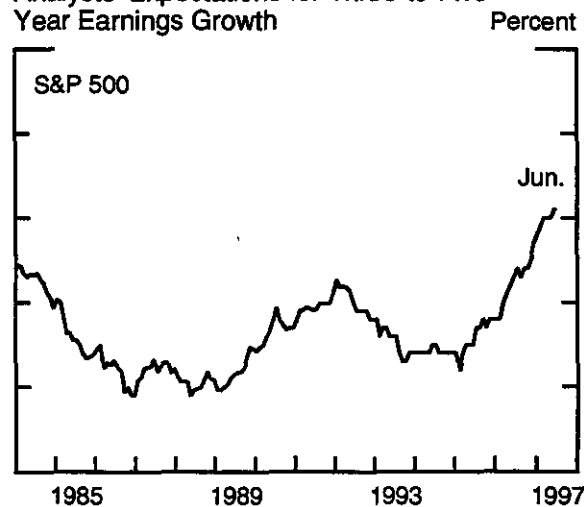
Chart 8

# Price-Earnings Ratio - S&P 500



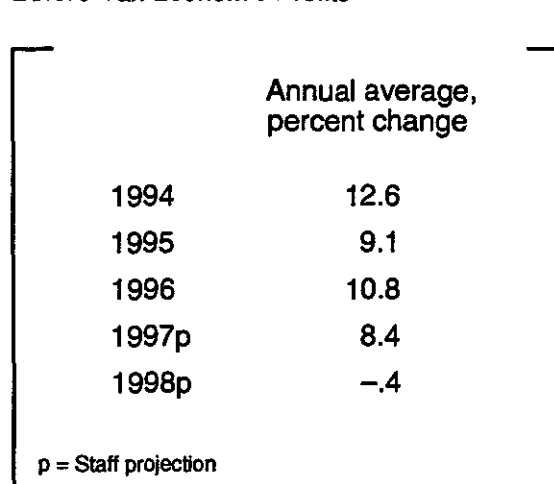
\* Source: Goldman Sachs

## Analysts' Expectations for Three-to-Five Year Earnings Growth

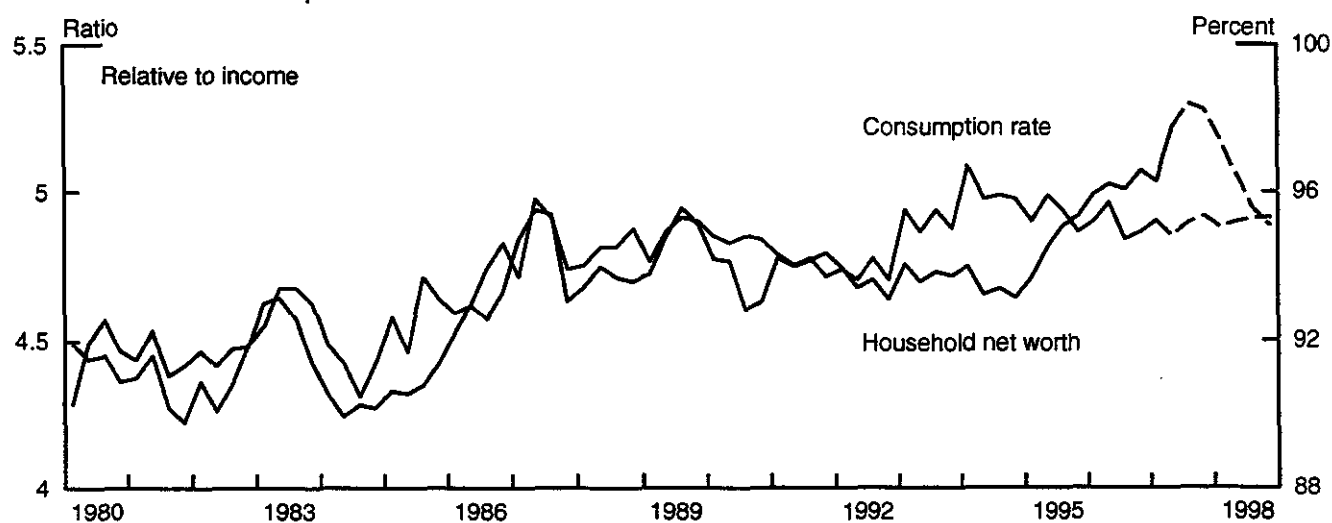


Source: I/B/E/S.

## Before-Tax Economic Profits



## Wealth and Consumption



Note: Consumption rate equals 100 minus the saving rate.

Chart 9

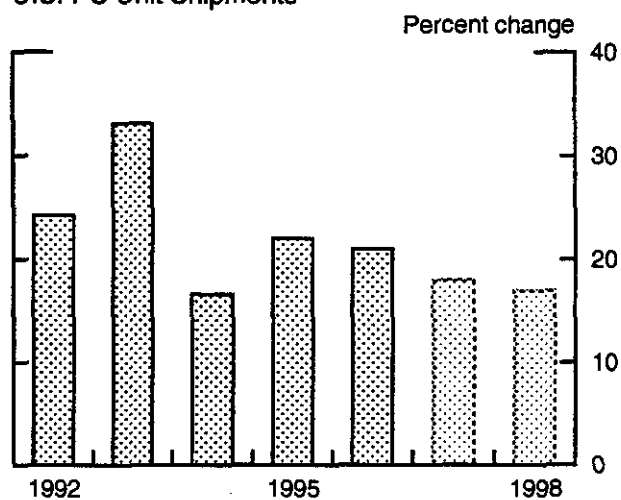
## Business Investment

### BFI Forecast

(Percent change, Q4 to Q4)

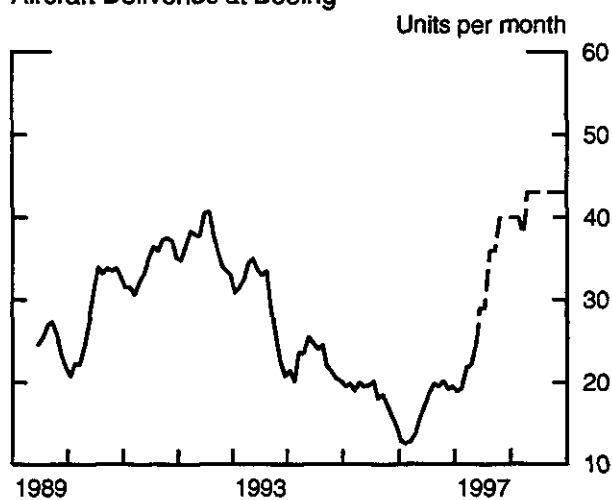
	1996	1997	1998
Producer's durable equipment	9.7	12.6	6.9
Computers	37.2	26.0	18.5
Aircraft	9.2	50.5	3.2
Other	2.1	6.4	.8
Nonresidential structures	9.0	4.5	4.3

#### U.S. PC Unit Shipments



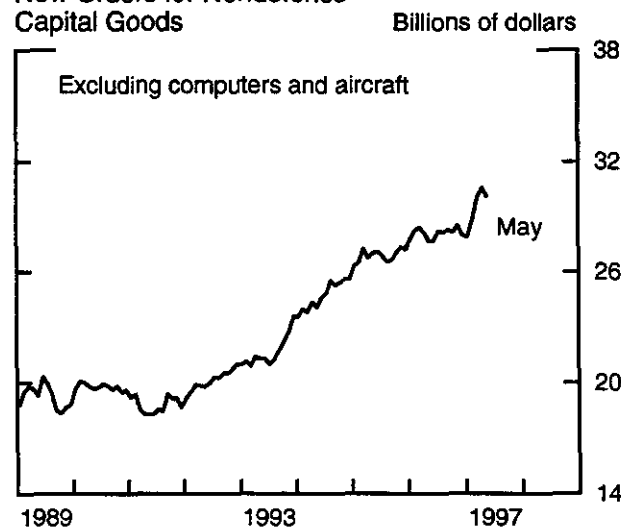
Source: Information Technology Industry Council

#### Aircraft Deliveries at Boeing



Note. Historical data are plotted as six-month moving average; forecast is Boeing's scheduled deliveries.

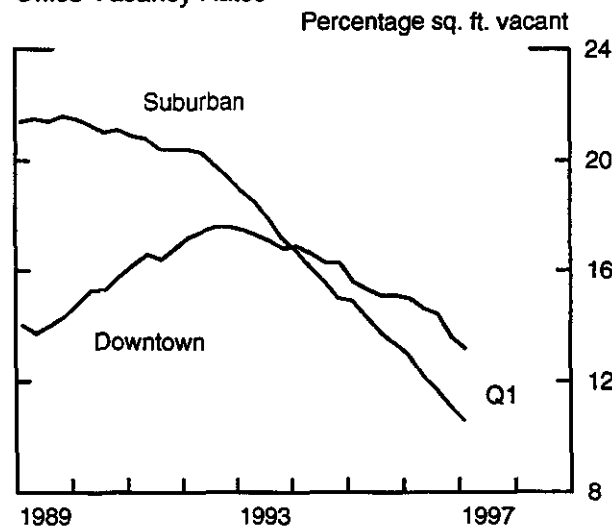
#### New Orders for Nondefense Capital Goods



Excluding computers and aircraft

May

#### Office Vacancy Rates



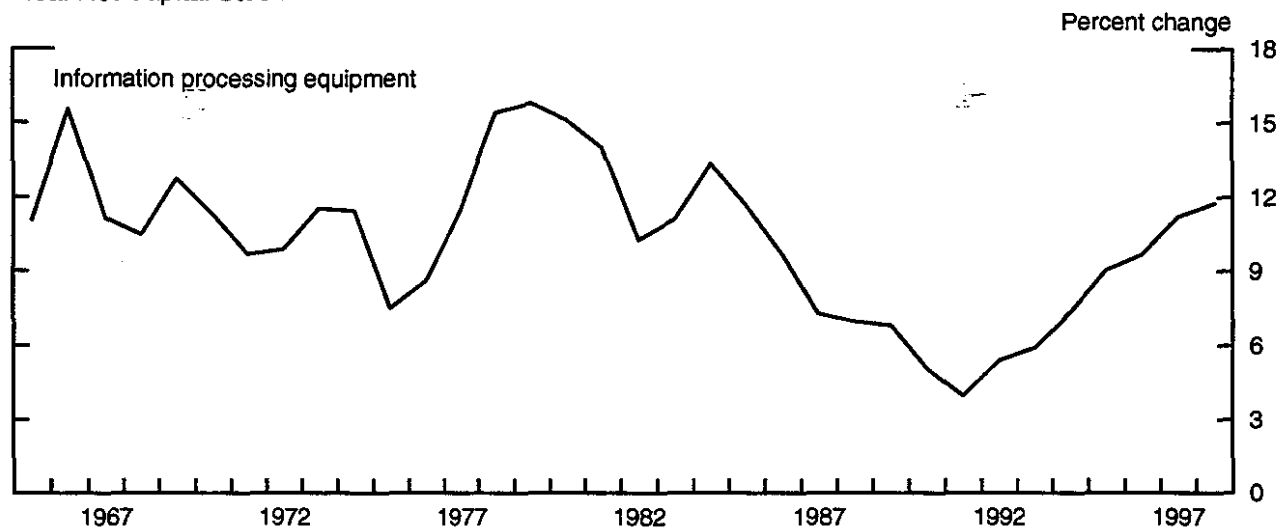
Suburban

Downtown

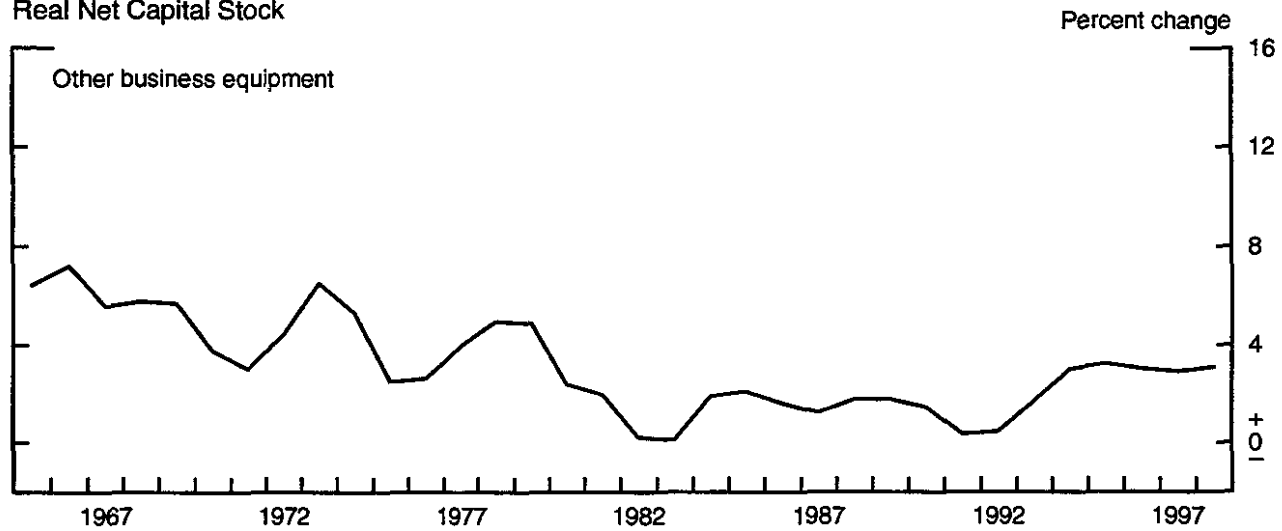
Q1

Chart 10

### Real Net Capital Stock



### Real Net Capital Stock



### Capital Labor Ratio\*



Chart 11

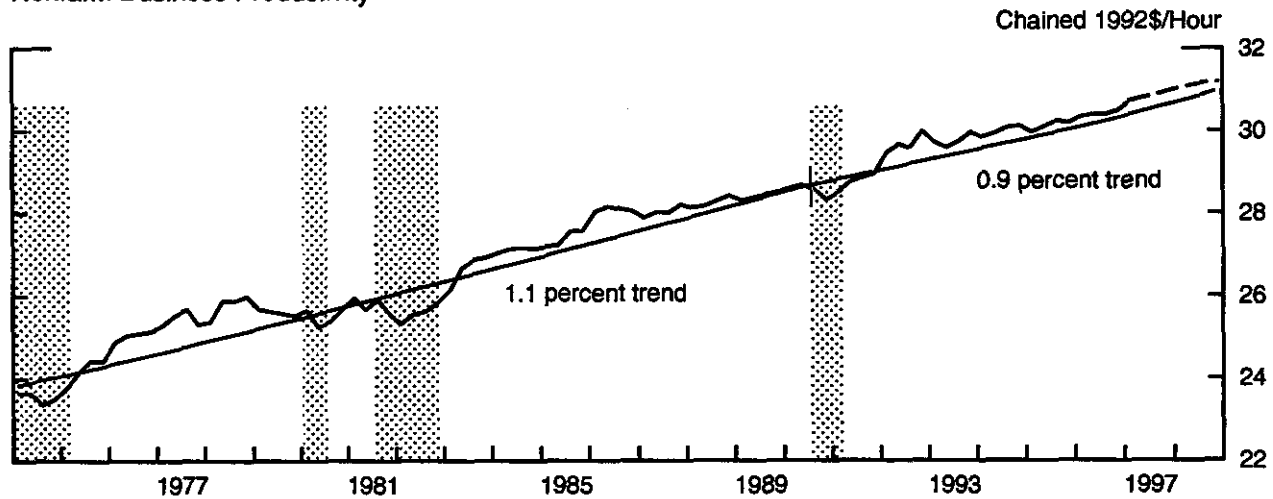
## The Supply Side

**Supply-side Components of Potential GDP**  
(Average annual growth rate)

	Long-term trends			Projection
	1960-73	1973-79	1979-90	1990-98
1. <b>Potential GDP</b>	<b>4.1</b>	<b>3.3</b>	<b>2.7</b>	<b>1.9</b>
2. Labor input	1.2	2.0	1.6	1.0
3. Labor productivity <sup>1</sup>	3.0	1.1	1.1	.9
4. Technical factors <sup>2</sup>	-.1	.2	.0	.0

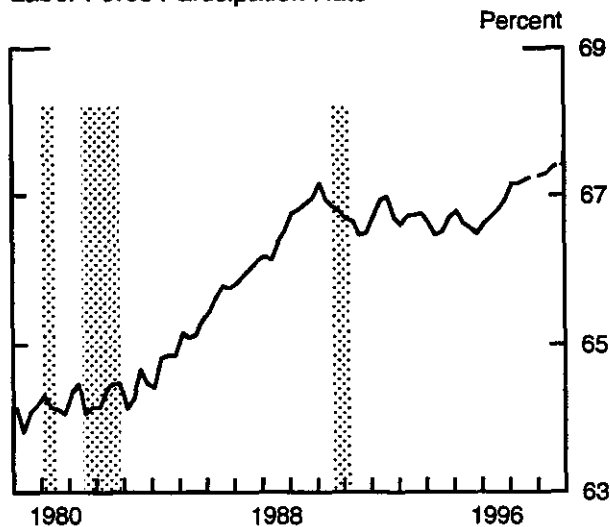
1. Nonfarm business sector.  
2. Technical factors include: the ratio of GDP to the output of the nonfarm business sector; the ratio of nonfarm business employment to household employment; and rounding error.

Nonfarm Business Productivity\*



\* Adjusted to reflect anticipated revision.

Labor Force Participation Rate



Note: Adjusted for CPS revision.

Labor Force and Employment\*

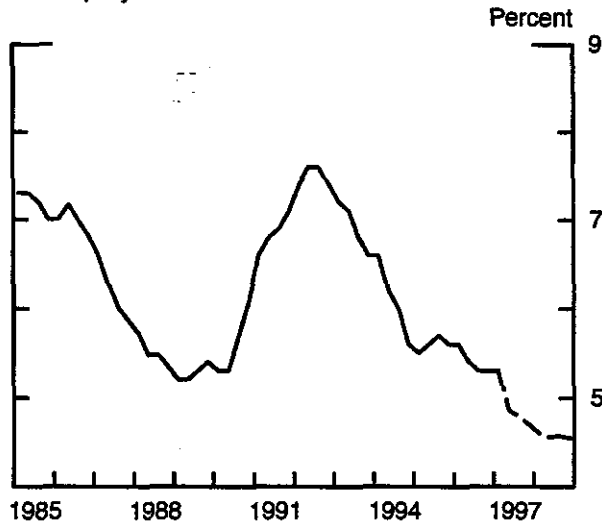
	Percent change, Q4 to Q4	
	Labor Force	Employment
1995	.5	.6
1996	1.8	2.0
1997	1.7	2.3
1998	1.2	1.4

\* Household survey

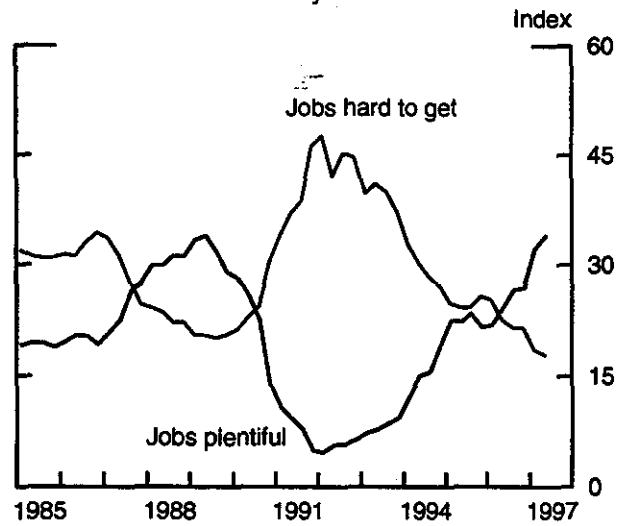
Chart 12

# The Labor Market

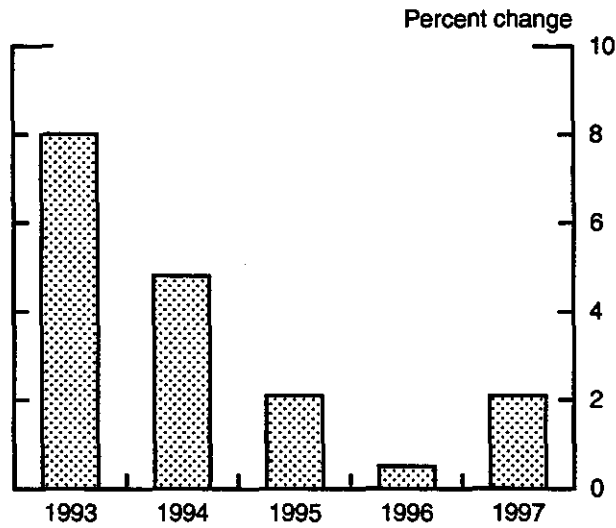
Unemployment Rate



Conference Board Survey

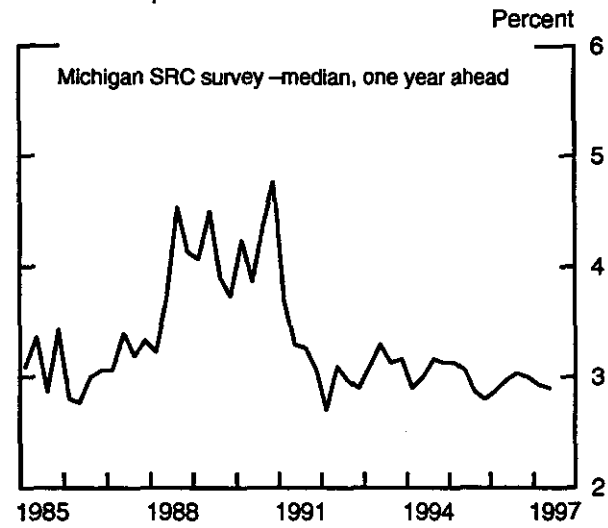


Health Insurance Premiums\*

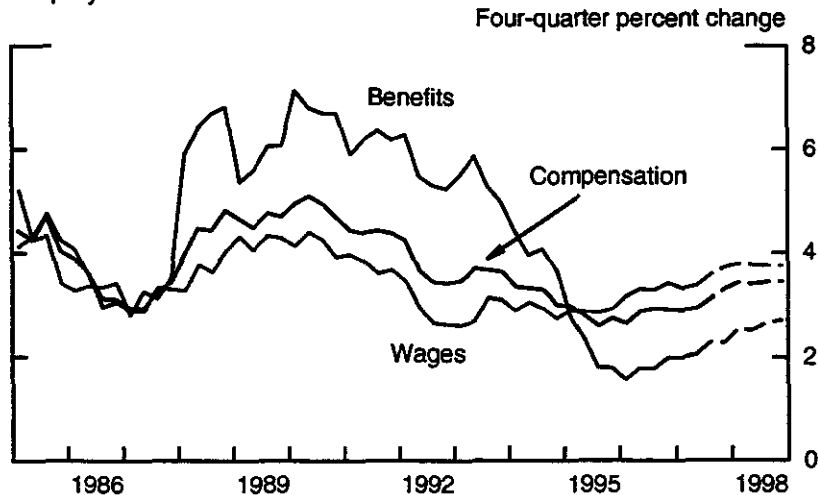


\* KPMG survey

Inflation Expectations



Employment Cost Indexes



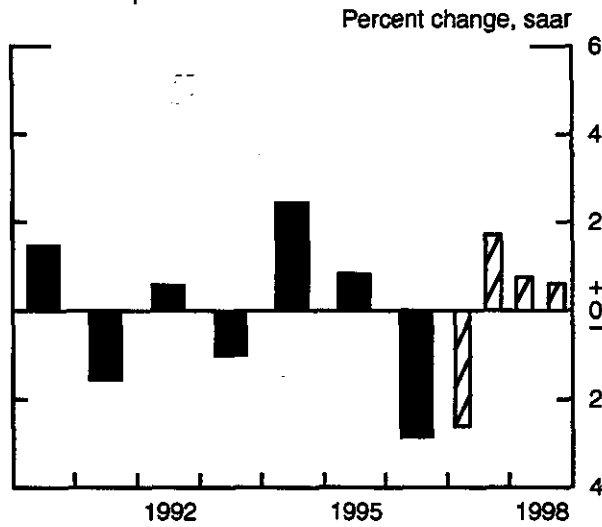
Q4/Q4 percent change

	<u>Comp</u>	<u>Wages</u>
1995	2.6	2.8
1996	3.1	3.4
1997	3.3	3.7
1998	3.4	3.8

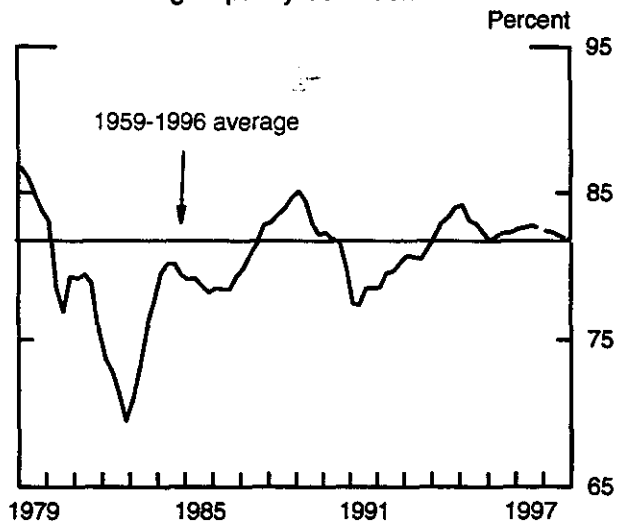
Chart 13

# Product Markets and Price Inflation

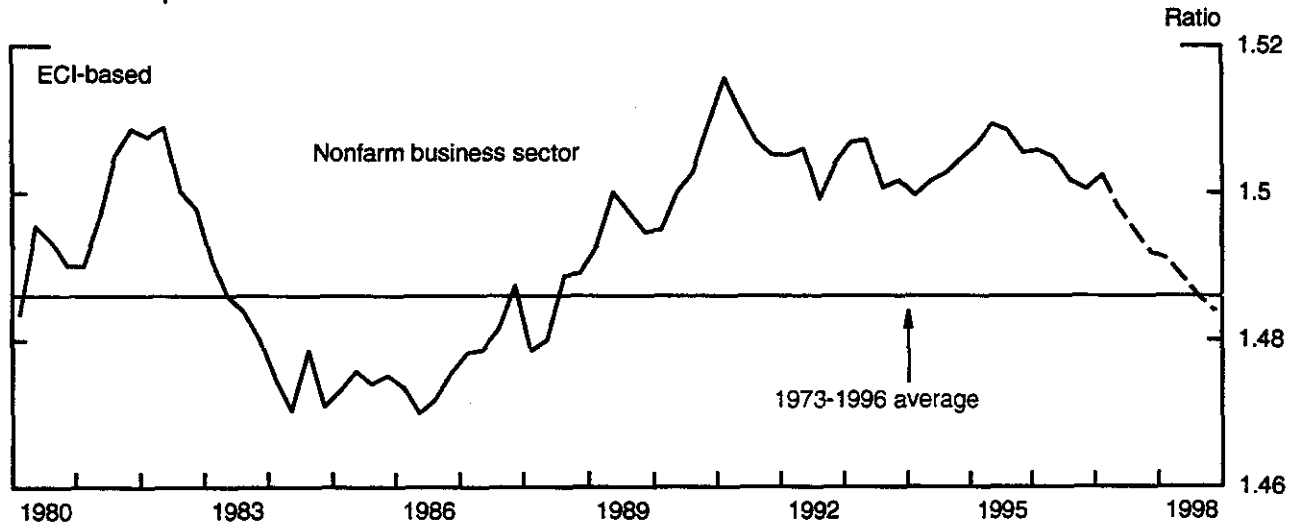
Non-oil Import Prices



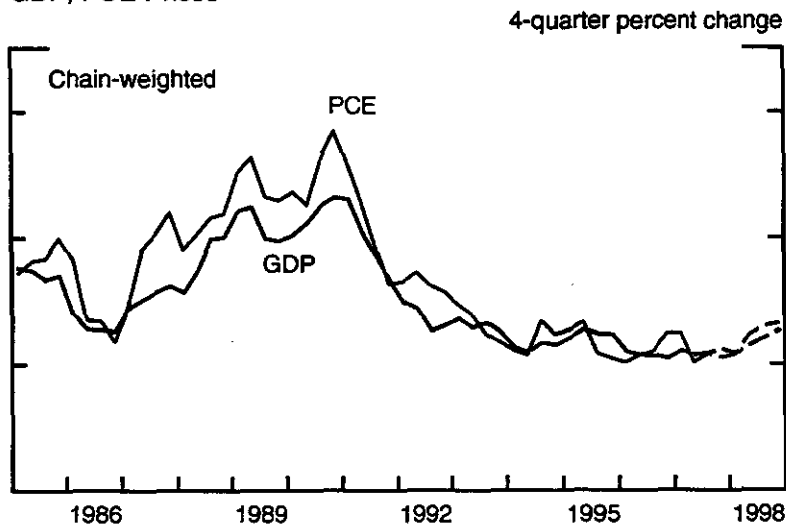
Manufacturing Capacity Utilization



Trend Markup of Prices over Unit Labor Costs



GDP, PCE Prices



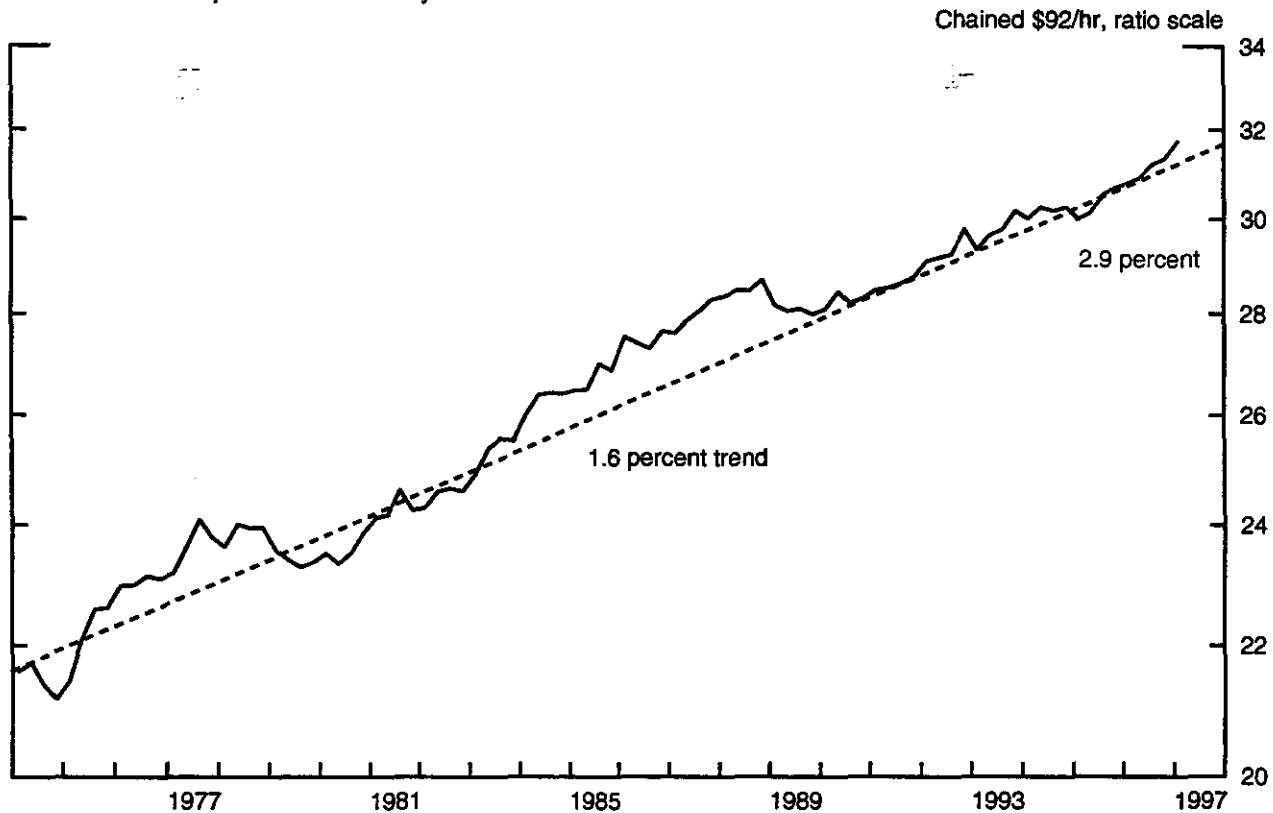
Q4/Q4 percent change

	GDP	PCE
1995	2.5	2.1
1996	2.1	2.5
1997	2.2	2.1
1998	2.5	2.6

Chart 14

## The Effects of Faster Productivity Growth

Nonfinancial Corporate Productivity



### The Supply-side Effects

- Initially, business profitability increases.
- Price inflation is reduced.
- Real wages rise more quickly through a combination of lower price inflation and some pickup in nominal wage inflation.

### The Demand-side Effects

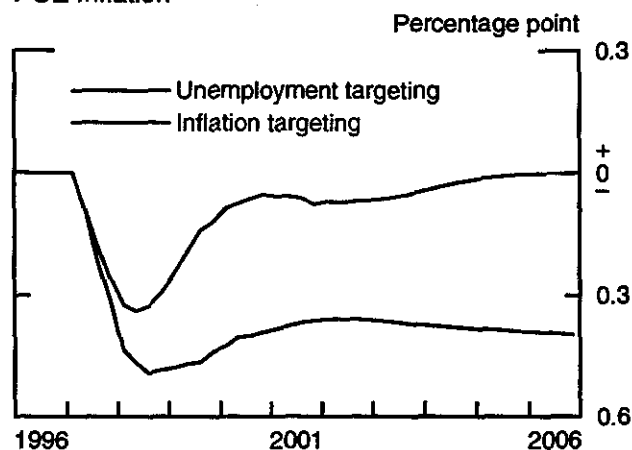
- Investment demand strengthens as firms expand capital spending to exploit enhanced profit opportunities.
- Consumer spending accelerates as households respond to higher permanent income.

Chart 15

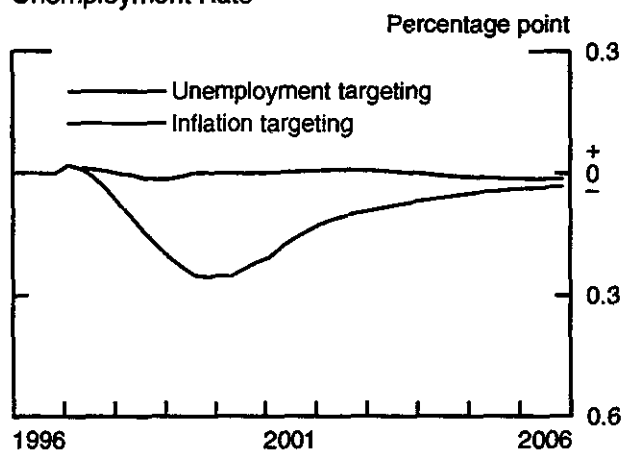
## Alternative Scenarios with Faster Productivity Growth

(0.5 percentage point per year faster productivity growth;  
deviations from baseline)

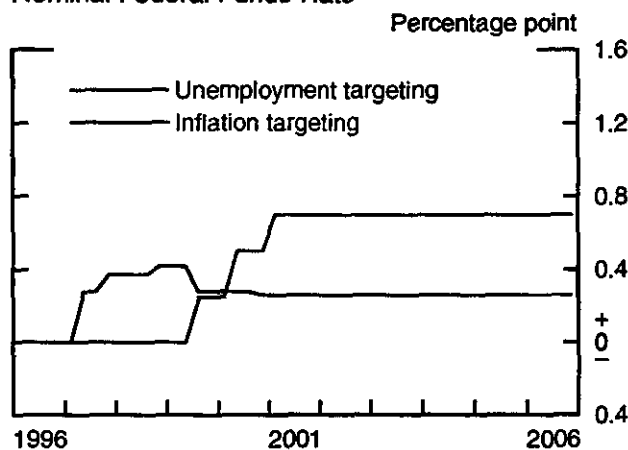
PCE Inflation



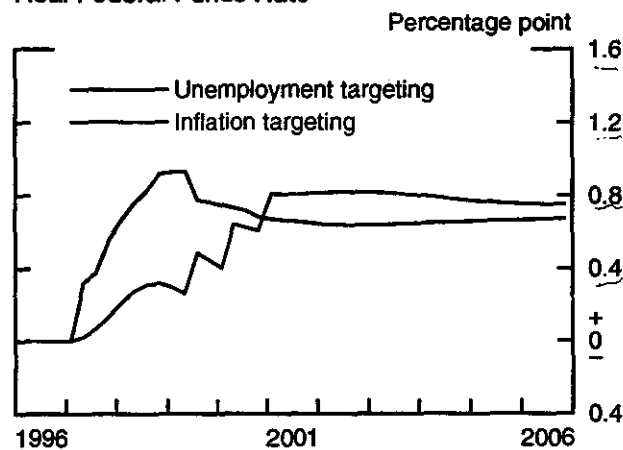
Unemployment Rate



Nominal Federal Funds Rate



Real Federal Funds Rate



Baseline and Alternatives

	1996	1997	1998	1999	2001	2006
<b>PCE Inflation (Q4 to Q4 percent change)</b>						
Baseline	2.5	2.1	2.6	2.9	3.2	3.2
Unemployment targeting	2.5	1.9	2.1	2.4	2.8	2.8
Inflation targeting	2.5	2.0	2.3	2.7	3.1	3.2
<b>Unemployment Rate (annual averages)</b>						
Baseline	5.4	4.9	4.6	4.8	5.6	5.6
Unemployment targeting	5.4	4.9	4.6	4.8	5.6	5.6
Inflation targeting	5.4	4.9	4.5	4.6	5.4	5.6



**ECONOMIC PROJECTIONS FOR 1997**

	FOMC		
	Range	Central Tendency	Staff
Percent change, Q4 to Q4			
Nominal GDP	5 to 6	5 to 5 <sup>1</sup> / <sub>2</sub>	5.4
previous estimate	4 <sup>1</sup> / <sub>4</sub> to 5 <sup>1</sup> / <sub>4</sub>	4 <sup>1</sup> / <sub>2</sub> to 4 <sup>3</sup> / <sub>4</sub>	4.6
Real GDP	3 to 3 <sup>1</sup> / <sub>2</sub>	3 to 3 <sup>1</sup> / <sub>4</sub>	3.4
previous estimate	2 to 2 <sup>1</sup> / <sub>2</sub>	2 to 2 <sup>1</sup> / <sub>4</sub>	2.3
GDP Price Index	2 to 2 <sup>1</sup> / <sub>2</sub>	2 to 2 <sup>1</sup> / <sub>4</sub>	2.2
CPI	2 to 2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>4</sub> to 2 <sup>1</sup> / <sub>2</sub>	2.2
previous estimate	2 <sup>3</sup> / <sub>4</sub> to 3 <sup>1</sup> / <sub>2</sub>	2 <sup>3</sup> / <sub>4</sub> to 3	2.6
Average level, Q4, percent			
Unemployment rate	4 <sup>3</sup> / <sub>4</sub> to 5	4 <sup>3</sup> / <sub>4</sub> to 5	4.7
previous estimate	5 <sup>1</sup> / <sub>4</sub> to 5 <sup>1</sup> / <sub>2</sub>	5 <sup>1</sup> / <sub>4</sub> to 5 <sup>1</sup> / <sub>2</sub>	5.1

**ECONOMIC PROJECTIONS FOR 1998**

	FOMC		
	Range	Central Tendency	Staff
Percent change, Q4 to Q4			
Nominal GDP	4 <sup>1</sup> / <sub>4</sub> to 5 <sup>3</sup> / <sub>4</sub>	4 <sup>1</sup> / <sub>2</sub> to 5	4.3
Real GDP	1 <sup>3</sup> / <sub>4</sub> to 3	2 to 2 <sup>1</sup> / <sub>2</sub>	2.1
GDP Price Index	2 <sup>1</sup> / <sub>4</sub> to 2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub> to 2 <sup>3</sup> / <sub>4</sub>	2.5
CPI	2 <sup>1</sup> / <sub>2</sub> to 3	2 <sup>1</sup> / <sub>2</sub> to 3	2.8
Average level, Q4, percent			
Unemployment rate	4 <sup>1</sup> / <sub>2</sub> to 5 <sup>1</sup> / <sub>4</sub>	4 <sup>3</sup> / <sub>4</sub> to 5	4.6

NOTE: Central tendencies constructed by dropping top and bottom three from distribution, and rounding to nearest quarter percent.